Amend Section 19311 of, and add Section 19316 to, the Revenue and Taxation Code to allow financial disability suspension of statute of limitations on income tax refund claims.

Source: Honorable Johan Klehs

Under **current federal law**, after filing an income tax return, a taxpayer may discover that they over-reported their income, which results in reducing their tax liability. Upon identifying this change, the taxpayer may file an amended return requesting a claim for refund. A claim for refund is a request by the taxpayer to have any overpaid income taxes refunded.

Taxpayers also may receive a proposed income tax assessment for a particular year. This assessment may state that the taxpayer did not file a return or the return understated the tax liability and additional tax is owed. In addition to other manners of disputing the assessment, a taxpayer may pay the assessment and file a claim for refund refuting the adjustments that resulted in additional tax.

Current federal law requires a taxpayer to file a claim for refund within the later of:

- Three years from the due date of the filing of the return or,
- Two years from the date of payment of the tax

A refund claim that is not filed within these periods is untimely.

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1997 (IRS Reform Act), among other things, allows a suspension of the statute of limitations (SOL) for filing a claim for refund where a taxpayer establishes that he or she was "financially disabled." Individuals are financially disabled if they are unable to manage their financial affairs because of a medically determinable physical or mental impairment that is expected to result in death or last for a continuous period of at least one year. An individual would not be considered financially disabled for any period that the individual's spouse or any other person is legally authorized to act on that individual's behalf in financial matters. The law does not specify a time limit on the suspension.

Under **current state income tax law**, the process for filing a claim for refund is basically the same as federal law. However, the state SOL differs from the federal SOL with respect to time frames.

Current state income tax law allows a taxpayer to file a claim for refund within:

- Four years from the due date of the return (without regard to extensions) or one year from the date of payment of tax, whichever is later;
- Two years from the date of a final federal determination; or
- Seven years after the due date of the return in the case of bad debts, worthless securities, or erroneous inclusion of recoveries.

However, the **current California Personal Income Tax Law (PITL)** does not have a financially disabled suspension of the SOL for income tax purposes.

Current Sales and Use Tax Law, as well as the various special taxes and fee programs administered by the Board of Equalization (BOE), contain similar SOL suspension provisions for the financially disabled that are contained in federal law. Therefore, the treatment of financially disabled individuals is different for state **income** tax purposes as contrasted with federal income tax and BOE administered business taxes. The BOE, which hears appeals of both income tax and sales and use tax matters, must by law render decisions with different results in income tax cases with claims of financial disability.

This proposal would amend the PITL to allow the SOL for filing claims for refund for income tax purposes to be suspended during periods where the taxpayer is financially disabled. A California taxpayer would receive the same treatment for state income tax purposes as for federal purposes when that taxpayer is determined to be financially disabled, which would also be consistent with the treatment under California's sales tax and special taxes laws. That is, financially disabled taxpayers would receive the same suspended SOL for tax matters pertaining to a claim for refund. This provision would be effective January, 1, 2003, and would apply to all periods of financial disability commencing before, on, or after this date. However, it would not apply to any claim barred by the SOL as of January 1, 2003.

Further, it would allow BOE to be consistent in its decisions regarding income tax claims, sales tax, and special taxes claims where financial disability is a factor.

Implementation of this proposal would occur during the department's normal annual updates.

FTB's Legal Branch receives approximately five to ten claims a year where the SOL would have been suspended had the PITL allowed the SOL suspension for financially disabled claimants. Further, it is not known how many financially disabled claims have been considered untimely and denied by the FTB audit branch since there is no current method of differentiating the financially disabled from other untimely claims.

Due to the similarity in income tax laws, the department reviewed the income tax laws of the states of Illinois, Massachusetts, Michigan, Minnesota, and New York. Based on the information available, it appears none of these states allows a suspension of the SOL based on a taxpayer being financially disabled.

Background. Proposed legislation that would have allowed the SOL suspension for income tax purposes has been carried in different bills in prior years. AB 1208 (Chesbro, 1999/2000) carried the suspension legislation along with numerous other items of proposed legislation. However, that bill failed to move out of the Senate Appropriations Committee and, as a result, died. AB 1633 (Ortiz, 1997/1998) also carried the suspension provisions with other provisions of the IRS Restructuring and Reform Act of 1997, but failed to pass the Assembly Appropriations committee and subsequently died.

This proposal would result in a revenue loss estimated by FTB to be $1 million for each fiscal years 2002-03 and 2003-04. Beginning 2004-05, and annually thereafter, the revenue loss would be less than $500,000.

Section 19311 of the Revenue and Taxation Code is amended to read:

19311**.** (a) If a change or correction is made or allowed by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, a claim for credit or refund resulting from the adjustment may be filed by the taxpayer within two years from the date of the final federal determination (as defined in Section 18622), or within the period provided in Section 19306, 19307, ~~or~~ 19308, or 19316 whichever period expires later.

~~(b) This section shall apply to any federal determination that becomes final on or after January 1, 1993.~~

Section 19316 is added to the Revenue and Taxation Code to read:

19316. (a) In the case of an individual taxpayer under the Personal Income Tax Law (Part 10 (commencing with Section 17001)), the running of any period specified in Section 19306, 19308, 19311, 19312, or 19313 shall be suspended during any period during which that individual taxpayer is “financially disabled: as defined in subdivision (b) . The financial disability of an individual taxpayer shall be established in accordance with those procedures and requirements specified by the Franchise Tax Board.

(b) (1) For purposes of this section, except as otherwise proved in paragraph (2), an individual taxpayer is “financially disabled” if that individual taxpayer is unable to mange his or her financial affairs by reason of a medically determinable physical or mental impairment that is either deemed to be a terminal impairment or is expected to last for a continuous period of not less that 12 months.

(2) An individual taxpayer shall not be considered to be “financially disabled: for any period during which that individual’s spouse or any other person is legally authorized to act on that individual’s behalf in financial matters.

(c) This section applies to periods of disability commencing before, on, or after the effective date of the act adding this section, but does not apply to any claim or refund that (without regard to this section) is barred by the operation or rule of law, including res judicata, as of the effective date of the act adding this section.